TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 02-19

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of sales and use tax to collectors' club memberships and tangible personal property transferred with the membership.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
(C) The applicable law must not have been changed or amended;
(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling, and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[THE TAXPAYER] is located in [CITY, STATE – NOT TENNESSEE]. For purposes of this ruling, it is assumed the Taxpayer has nexus with Tennessee. The Taxpayer is

engaged in the wholesale sale of collectibles and giftware, and sells memberships in [NUMBER] collectors' clubs – [NAMES OF CLUBS]. The Taxpayer's most prominent product line is its [PRODUCT] that are sold largely to collectors. The Taxpayer also sells several other lines of [PRODUCT] collectibles. Most of the [PRODUCT] are sold at retail shops such as [NAME OF STORE CHAIN] and other gift stores. Due to the popularity of the [PRODUCT] and the propensity of its end customers to collect the [PRODUCT], [THE TAXPAYER] has formed collectors' clubs of [NUMBER] of its product lines.

A prospective club member generally picks up a membership application at a local retail shop and mails it, with his or her remittance, to the Taxpayer in [CITY, STATE – NOT TENNESSEE]. The company also mails applications to potential club members from lists that are either developed internally or purchased. The individual may purchase a one or two year membership, payable in advance.

Membership confers a number of benefits. Club members become eligible to purchase exclusive members-only [PRODUCT]. They receive a quarterly newsletter, and they are invited to attend special shows, to attend members-only events at collectors' conventions, and to go on collectors' cruises. The conventions feature seminars on crafts, interactive games, cross-stitching sessions, a paint your own collectible session, a seminar on new products, dinners and a dance. The offerings at particular conventions vary from time to time.

When an individual purchases a membership, he or she receives a "Club Kit." If a two-year membership is purchased, a second Club Kit is sent on the first day of the following year. The Club Kit generally includes a "symbol of membership" [PRODUCT], decorative packaging, [TANGIBLE PERSONAL PROPERTY] and other ancillary items.

The Taxpayer states a recent survey conducted by an independent research firm shows that seventy-four percent (74%) of the members join the [NAME OF CLUB] to have the opportunity to purchase members-only collectibles though only twenty to forty percent (20%-40%) of the members actually make such purchases. The Taxpayer states that marketing experts believe the status of being a member of the club is what attracts members. The Taxpayer believes the tangible personal property transferred to its customers with their membership is not the "true object".

The membership fees charged, and the approximate cost of the Club Kits for 2001 are set forth as follows:

	Membership Fee	Cost of Club Kits
[NAME OF CLUB]	$[AMOUNT]	$[AMOUNT]
[NAME OF CLUB]	[AMOUNT]	[AMOUNT]
[NAME OF CLUB]	[AMOUNT]	[AMOUNT]

ISSUES

1. Is the Taxpayer liable for sales or use taxes on its membership fees?

2. Is the Taxpayer liable for use taxes on the cost of the Club Kits shipped to Tennessee Club members by common carrier from outside Tennessee.

3. If the Taxpayer is liable for use taxes on the cost of the Club Kits, is the Taxpayer entitled to credit for tax properly paid to the state in which the Club Kits were manufactured, purchased or shipped?

RULINGS

1. Yes.

2. No tax is due on the cost of the Club Kits since the Taxpayer is liable for sales or use taxes on its membership fees that include the transfer of tangible personal property.

3. Since the Tennessee tax is not imposed upon the Taxpayer's cost of the Club Kits, credit for taxes paid to other states on its cost would not be available.

ANALYSIS

In Tennessee, there is only one sales tax case directly on the subject of memberships in buying clubs. In *Barnes & Noble Superstores, Inc, v. Huddleston*, 1996 WL 596955 (Tenn. Ct. App. 1996), the taxpayer, a bookstore sold its customers membership in the "Readers Choice Club". This entitled members to a 10% discount on future purchases of bookstore merchandise upon display of the membership card. The taxpayer alleged that the $10.00 fee represented payment for membership in a discount buying club that was not taxable because it did not involve the sale of tangible personal property. The taxpayer said the fee was in exchange for the intangible privilege of receiving a discount on merchandise, not taxed under the applicable statutes. On the other hand, the Department contended the membership cards themselves were tangible personal property subject to sales tax. Alternatively, the Department of Revenue asserted, the sale of the

cards for $10.00 constituted prepayment for merchandise. *Id*. 1996 WL 596955, *3 (Tenn. Ct. App.).

In this case the Court ruled in favor of the taxpayer and stated:

> The determinative inquiry in this case is whether the sale of discount cards constitutes a prepayment for merchandise….
>
> After evaluating the applicable statutes in light of the circumstances of the case sub judice, it is our opinion that Bookstar's sale of discount club memberships is not subject to sales tax. The Commissioner's prepayment argument must fail for the simple reason that a member has no obligation ever to purchase any merchandise. The true object of the subject transactions between Bookstar and its customers is to bestow upon club members the intangible right to receive a discount on merchandise. The membership card is merely an indicia of that intangible right and incidentally aids in the exercise of that right. The club member may ultimately elect not to avail himself of the privilege of buying anything.

Of course, *Barnes & Noble* is clearly distinguishable from the facts presented by this ruling because the membership fee for the buying club in that case did not involve a contemporaneous transfer of tangible personal property. Indeed, the Court of Appeals concluded (at least from a theoretical point of view) a club member might never purchase any tangible personal property. Under *Barnes & Noble,* the prospect of future purchases is clearly insufficient to justify application of the sales tax to membership fees in a buying club. However, the Court left unanswered the question of how the tax should apply if a buying club member also received tangible personal property along with the club membership. Other Tennessee cases must be examined to obtain guidance on application of the sales tax when a service is combined with the contemporaneous transfer of tangible personal property.

In *Nashville Clubhouse Inns v. Johnson*, 27 S.W.3d 542 (Tenn. Ct. App. 2000) the Court considered the application of the sales and use tax to the taxpayer's purchases of food and beverages to be transferred to customers along with the rental of rooms. The taxpayer charged a flat rate for the rental of rooms, but included food and beverages. The food and beverages were advertised as "free". Therefore, the Department considered the food and beverages to be given away and not resold by the taxpayer. Accordingly, the taxpayer was assessed use taxes on these food and beverage purchases. The taxpayer was treated as the user and consumer of the "free" food and beverages provided to its customers. However, the taxpayer claimed the "free" food and beverages were actually resold along with the taxable rental of rooms. Even though the taxpayers' customers were not separately charged for the "free" food and beverages, the taxpayer asserted its purchases were properly exempted from tax as "sales for resale."

After noting that:

> …there is no regulation stating that a hotel will be considered the user or consumer of

items of food and drink that are served to guests without a specific charge therefor.

Id. p. 546. The Court analyzed the existing Tennessee case law and deduced two alternative tests for the determination of whether tangible personal property is resold by a service provider.

> First, if taxpayers who are service providers purchase tangible personal property that is used to enable them to provide their service, then they are not reselling the tangible personal property and must pay sales tax on the property.
>
> …
>
> *Second, if a taxpayer who is a service provider purchases tangible personal property that could have a value independent from the service the taxpayer provides, the taxpayer need not pay tax on the equipment.*
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> …
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> The food and beverages purchased by the hotels were not only sold to registered guests but also to persons who were not registered guests. Accordingly, the food had an independent value to the hotels, and the hotels were not required to pay tax on the food and beverages when they purchased them. *See: Cape Fear Paging Co. v. Huddleston*, 937 S.W.2d 787 (Tenn. 1996) and *Nashville Mobilphone Co. v. Woods*, 655 S.W.2d 934, 937 (Tenn. 1983).
>
> …
>
> [T]he issue in this case is whether the hotels were selling breakfasts and beverages "as such" to their registered guests. In order for there to be a sale, there must be a transfer of title or possession and consideration. There was a transfer of possession of the food from the hotels to their registered guests, and there was consideration for the transfer because the proof is undisputed that the cost of providing the food and beverages was included with the room as part of a package deal. Surely a registered guest would have had a contractual right to demand breakfast or beverages had one of the hotels declined to give it to him or her.

Nashville Clubhouse Inns v. Johnson, 27 S.W.3d 546,547 (Emphasis mine). The Court found the necessary elements of a sale existed. Nashville Clubhouse Inns transferred possession of the food and beverages. The Court also determined there was consideration for the food and beverages since the cost of the food and beverages were incorporated into the flat rate charge for the room. In finding a sale took place, the Court noted the customer had a contractual right to receive the "free" food and beverages. Even though the necessary statutory elements of a sale of food and beverages existed in the *Nashville Clubhouse Inns* case, it was also necessary for the Court to apply further tests established by case law in Tennessee. These further Court mandated requirements applied because the sale involved a mixture of services and tangible personal property. However, the first test developed by the Court from its review of Tennessee cases was clearly inapplicable

to the facts. Therefore, the Court applied the "second test" to determine if the food and beverages had an independent value to the taxpayer.

The charges for the food and beverages were not separated from charges for the room rentals so there was no *prima facie* indicator of an independent value for the food and beverages. However, the taxpayer also operated a restaurant that sold food and beverages to persons who were not registered guests. Since the taxpayer was also separately engaged in the business of selling food and beverages, these items provided to registered guests for no additional charge were shown to have an independent value to the hotel. The transfer of the tangible personal property was not just incidental to the service being provided. The second test was met, and the food and beverages could be purchased by the taxpayer exempt from tax as purchases for resale.

Nashville Clubhouse Inns differs from this ruling in that the service sold with the tangible personal property was a taxable service. The total charge for the sale of the service including the tangible personal property was already being taxed. However, the tests established by this case seem equally applicable when the service is nontaxable. There is consideration for the Club Kits built into the membership fee. Also, title and possession passes to the members. Since the Taxpayer is primarily in the business of selling [PRODUCT] and their accessories, it is apparent these items provided with the buying club memberships also have an independent value to the Taxpayer. The "second test" for determining if a service provider is reselling tangible personal is met. *Nashville Clubhouse Inns* supports the conclusion that the Taxpayer is reselling the Club Kits. Accordingly tax must be collected upon this resale to Tennessee consumers.

While the "true object" test was not specifically mentioned or applied in the *Nashville Clubhouse Inns* case, another recent Tennessee case applied the "true object" test. *Equifax Check Services, Inc. v. Johnson,* 2000 WL 827963 (Tenn. Ct. App. 2000) involved a mixture of taxable and nontaxable services. Equifax provided check guarantee services to merchants that accepted personal checks from their customers. Most of Equifax's check approval services were provided by the use of telecommunications, and, in fact, telecommunications were essential to Equifax's method of operation. Telecommunication services are subject to the Tennessee sales tax, but check guarantee services are not. The taxpayer did not separate the charge for telecommunication services from the charges for the check guarantee service so the Department applied the sales tax to the total charge. In this case, the Court determined the telecommunication services were not being resold by the taxpayer. Therefore, the taxpayer's charges for its services were not subject to the sales tax.

The Court said:

> Although telecommunications services are essential to Equifax Check's guarantee services, telecommunication services are merely a means for delivering those check guarantee services and, as such, are merely *incidental* to the provision of those services.

Id. p. 2. (Emphasis mine).

> Although this information was communicated via telecommunications, *Equifax was not in the business of providing telecommunication services to the merchants*. As pointed out by the trial court, the telecommunications used to convey this information had no value to the merchant separate and apart from the check guarantee services provided by Equifax.

Id. p. 3. (Emphasis mine).

> Telecommunication was merely the method of transmitting this information to Equifax's merchants. Stated another way, *the true object* of the transactions was not telecommunication services, but the information itself. Although Equifax admittedly relied upon telecommunications to transmit the information, telecommunications were not required for the information to exist.

Id. p. 4.

In summary, the Court determined the telecommunication services provided by the taxpayer though essential were merely "incidental" to the check guarantee services provided. Telecommunications was a necessary medium for the provision of the check guarantee service, but the taxpayer did not separately bill for this service. The taxpayer was not in the business of selling telecommunications, and the telecommunication service had no value to the taxpayer's customer separate and apart from the check guarantee service. The telecommunications service was not the "true object" of the transactions.

The Club Kits are not merely incidental to the sale of the Taxpayer's buying club memberships. As previously noted, these Club Kits have an independent value to the Taxpayer as well as to the customers. The "true object" test discussed in *Equifax* is very similar in application to the tests developed by the Court in *Nashville Clubhouse Inns*. In both cases, the Court looked to whether there was an independent value of the included items or services, and whether the taxpayer was in the separate business of selling the included items or services. In both cases, an important factor in this determination was whether the taxpayer was in the separate business of selling the alleged taxable item or service. The "true object" test as applied by *Equifax* also supports the view that the Club Kits are resold.

In *Thomas Nelson v. Olsen*, 723 S.W.2d 621 (Tenn. 1987) the Tennessee Supreme Court considered a combination of tangible personal property and non-taxable services. The Court held that advertising design models received pursuant to contracts with an Illinois company for the development of advertising ideas were tangible personal property subject to the use tax in the hand of the taxpayer/consumer. The Court applied the compensating use tax to the total charges made by the out-of-state vendor.

> The conclusion is inescapable that the statutory language prescribed by the legislature as defining the scope of the state use tax encompasses the transactions in which Taxpayer received these models. Unless Taxpayer is able to show some valid reason

> as to why these models should be exempted from the reach of the use tax, the entire costs of the transactions between American Motivate and Taxpayer must be subject to the tax. *See McKinnon & Co. v. State*, 174 Tenn. 619, 130 S.W.2d 91 (1939). The bare assertion that the creation of these models constituted a minute part of what was actually a contract to provide a service does Taxpayer no good. Such an interpretation of Tennessee's Sales and Use Tax has previously been considered and rejected by this Court as administratively unworkable. *Saverio v. Carson*, 186 Tenn. 166, 208 S.W.2d 1018 (1948).

Id. p.622. The Court also stated in upholding the tax:

> We believe that this fact warrants a conclusion that these models were more than merely incidental by-products to the purchase of intangible intellectual property.

Id. p. 624. Clearly, the Court would have reached the same result if it had been the sales tax instead of the compensating use tax that was being considered. The models were more than incidental to the sale of services so the tax was applied to the total charge.

Saverio v. Carson, 208 S.W.2d 1018 (Tenn. 1948), cited above in *Thomas Nelson,* is the oldest Tennessee Supreme Court decision on this subject. It has since been cited with approval by the Court as noted in the *Thomas Nelson* case above. *Saverio* addressed the mixed sale of the rental and cleaning of tangible personal property with no separation of the charges.

The taxpayer operated a laundry and a diaper service in Nashville. The taxpayer used its own diapers in providing the diaper service. A significant portion of the charge for the diaper service related to the cleaning of the diapers. Laundry services were not subject to the sales tax at that time. However, charges for the rental of tangible personal property were taxable. The taxpayer made a specific charge for the entire diaper service including the rental services. There was no separation of the charges for the different services provided. Therefore, the State assessed sales tax upon the entire charge for the diaper service as a rental. The taxpayer contended most of the charge for furnishing diapers to customers was a service charge rather than a rental charge, but the Court upheld the application of the tax to the total charge.

The Court said:

> Our statute is plain in that the tax must be paid on the final rental or selling price, even though this price includes service charges…. The maxim *de minimis non curat lex* has no application in the present cause. The measure of the tax is the gross proceeds of the rental paid by the lessee to the lessor without any deduction for service charges, regardless of how small may be the percentage of the return on the property rented.

Saverio v. Carson, p. 1019. The current law retains the definition of the selling price (i.e. tax base) relied upon by the Court. "Sales price" means:

> … the total amount for which a taxable service or tangible personal property is sold, including any services that are a part of the sales of the tangible personal property… without any deduction for service costs …or any other expense whatsoever;…

The Court determined any attempted division or separation of the charge for services rendered would result in confusion in the administration of the sales tax law, and render the law unworkable. *Id*. p. 1018. Clearly, in this case, the Court was unwilling to separate the taxable from the non-taxable in a case where the taxpayer had not separately billed its customers. Later cases indicate a separation of taxable and optional nontaxable items in charges made by a taxpayer will be given effect. *See: Penske Truck Leasing Co. v Huddleston*, 795 S.W.2d 669 (Tenn. 1990), and *Tomkats Catering, Inc. v. Johnson,* 2001 WL 1090516 (Tenn. Ct. App.)

Since the Taxpayer is selling tangible personal property in the form of the Club Kits under the various tests applied by the Tennessee Courts, the next step is to determine the tax base for application of the tax. However, the Taxpayer's sales of the Club Kits are not separated from its sales of memberships. It would be confusing and administratively unworkable for the Department to attempt to separate the taxable charges from the nontaxable in this case. *Saverio v. Carson*, 208 S.W.2d 1018 (Tenn. 1948), as well as long-standing Department interpretation,[1] indicate that the total charge should be taxed. Therefore, the membership fees are subject to sales and use taxes in Tennessee.

Tennessee allows credit against the compensating use tax for taxes paid to other states on the same transaction. *See*: Tenn. Code Ann. § 67-6-507(a). However, the taxable transaction in Tennessee is not the Taxpayer's purchase of materials used in the Club Kits. It is the sale of the Club Kits to Tennessee customers. Therefore, taxes imposed by other states on the Taxpayer's purchases of the components of the Club Kits may not be credited against the tax due to Tennessee.

Charles T. Moore
Special Tax Counsel

APPROVED: Ruth Johnson
Commissioner

DATE: 6/7/02

[1] *See* TENN. COMP. R. & REGS. 1320-5-1-22(4), 1320-5-1-23(1), 1320-5-1-25(1), 1320-5-1-41, 1320-5-1-61(2), 1320-5-1-99(3) for numerous examples where failure to bill a separate charge for a nontaxable item sold with a something taxable causes the entire charge for both to be subject to tax.